TEXAS TRANSPORTATION COMMISSION

ALL Counties | **MINUTE ORDER** |

ALL Districts

Pursuant to various provisions of Texas law, the Texas Transportation Commission (commission) is authorized to issue and incur obligations for transportation and other projects.

To ensure that all financings undertaken by the commission and/or the Texas Department of Transportation (department) are effected in accordance with the highest standards of industry, law, and government practice, and to confirm the intent of the commission and the department to adhere to sound financial management practices, the commission initially adopted a Debt Management Policy in Minute Order 110656 on August 24, 2006. The policy requires an annual review and, if necessary, amendment. The Debt Management Policy attached hereto as Exhibit A has been reviewed and presented to the commission for consideration.

The Debt Management Policy establishes parameters within which to administer the commission's financing programs, and such parameters focus on acceptable levels of risk, minimizing interest costs, optimizing future flexibility, and achieving and maintaining the best possible credit ratings.

Pursuant to Chapter 1371, Texas Government Code, and other applicable Texas law, the commission is authorized to execute credit agreements including interest rate swap and other similar agreements.

To establish responsibilities, objectives, and guidelines for the use of interest rate swap and other similar products in order to efficiently and prudently manage the commission's asset/liability profile for each financing program the commission initially adopted a Derivative Management Policy as a subsidiary component of the Debt Management Policy, also in Minute Order 110656 on August 24, 2006. The policy also requires annual review and, if necessary, amendment. The Derivative Management Policy attached hereto as Exhibit B has been reviewed and presented to the commission for consideration.

IT IS THEREFORE ORDERED by the commission that the Debt Management Policy attached hereto as Exhibit A and Derivative Management Policy attached hereto as Exhibit B have been reviewed and are hereby approved.

Submitted and reviewed by:

DocuSigned by:
Benjamin H. Asher
E40115FC36E4474...

Director, Project Finance,
Debt & Strategic Contracts Division

Recommended by:

DocuSigned by:
James M Bass
A36629BA547D4BD...

Executive Director

115837	Aug 27 2020
Minute Number	Date Passed

Debt Management Policy

Updated August 27, 2020

Table of Contents

1. Policy Objectives and Philosophy

The purpose of this Debt Management Policy ("Policy") is to ensure that all Financing Programs (as defined herein) undertaken by the Texas Transportation Commission ("Commission") and/or the Texas Department of Transportation ("TxDOT" or "Department") are completed in the most efficient manner and in accordance with the highest standards of industry, law and government practice. This Policy confirms the intent of the Department and the Commission to adhere to sound financial management practices including full and timely payment of all borrowings, and achieving the lowest cost of capital within prudent risk parameters.

The Commission intends to use its Financing Programs efficiently to maximize the delivery of transportation and mobility projects throughout the State within acceptable levels of risk, balancing obtaining the best possible credit ratings, minimizing interest costs and optimizing future flexibility. Due to the wide variety of projects and available Financing Programs, this policy sets parameters within which flexibility is retained to respond to specific or unplanned circumstances.

2. Scope and Authority

This Policy shall govern the management of all Financing Programs of the Commission or TxDOT and debt issued by related entities on behalf of the Commission or the Department if adopted by their boards. This Policy pertains to all new money obligations and refunding obligations and has been reviewed and approved by the Commission as of the date specified on the cover of this document. The Commission will review this Policy annually and will approve changes to the Policy when it concludes that doing so advances TxDOT's fiscal management goals and objectives and is fiscally prudent based upon recommendations from the Chief Financial Officer ("CFO") or the Project Finance, Debt and Strategic Contracts Division ("PFD") Director as his designee. Such amendments shall be evidenced in writing and the most current Policy will be posted to the TxDOT web site.

Management responsibility for this Policy is hereby delegated to the CFO. The CFO shall have responsibility and authority as provided by the Commission for structuring, implementing, and managing all Financing Programs, and for ensuring compliance with this Policy.

3. Currently Authorized Financing Programs

The Commission has authority to issue bonds, notes and other obligations for several "Financing Programs" as briefly described below:

a. **Texas Mobility Fund Revenue Financing Program ("TMF"):** Authorized by Article III, Section 49-k of the Texas Constitution and Subchapter M, Chapter 201, Texas Transportation Code, TMF bonds are secured by revenues deposited into the Texas Mobility Fund and, at the option of the Commission, the full faith and credit of the State of Texas. The proceeds of bonds may be used to fund state highway improvement projects, publicly owned toll roads, and other public transportation projects and to establish a loan program for qualified mobility projects. TMF bonds may have a maturity of no longer than 30 certain years and bonding capacity is constrained by statutory debt service coverage requirements as certified by the Comptroller. Effective June 10, 2015 the Commission may issue obligations only to refund outstanding obligations to provide savings, to refund variable rate obligations and to renew or replace credit agreements.

b. **State Highway Fund Revenue Financing Program ("SHF"):** Authorized by Article III, Section 49-n of the Texas Constitution and Section 222.003, Texas Transportation Code, SHF obligations (also called "Proposition 14" Bonds) are secured by a pledge of, and are payable from, revenues deposited to the State Highway Fund. Under current statutory authority, proceeds may be used for highway improvement projects; however $1.2 billion must be used for safety projects. State Highway Fund Revenue

Bonds may have a maximum maturity of 20 years and up to $6 billion aggregate principal amount may be issued pursuant to current statutory authority. The Commission has utilized all statutory authority to issue bonds for new money purposes and thus may only issue bonds to refund outstanding obligations and to renew or replace credit agreements.

c. **Highway Improvement General Obligation Bond Program ("HIGO"):** Article III, Section 49-p of the Texas Constitution and Transportation Code 222.004 authorize the issuance of up to $5 billion in general obligation bonds for highway improvement projects. HIGO bonds were approved by the voters in 2007 under ballot Proposition 12 and are thus referred to as "Proposition 12" Bonds. HIGO bonds may have a maximum maturity of no longer than 30 years. The Commission has utilized all statutory authority to issue bonds for new money purposes and thus may only issue bonds to refund outstanding obligations.

d. **Short-Term Obligations:** As authorized by Article III, Section 49-m of the Texas Constitution and Section 201.115, Texas Transportation Code the Commission and the Department may issue notes or borrow money from any source to carry out the functions of the Department. Such obligations are payable only from funds appropriated by the State legislature, including State Highway Funds, and must mature within two years of issuance. The amount of a loan may not exceed an amount which is two times the average monthly revenue deposited to the State Highway Fund for the twelve months preceding the month of the loan.

e. **Highway Tax and Revenue Anticipation Notes ("HTRANs"):** Article III, Section 49-n and Chapter 201, Subchapter N, Texas Transportation Code authorize the Commission to issue HTRANs in anticipation of a temporary shortfall in the State Highway Fund during any fiscal year. Obligations are payable from the State Highway Fund and are subject to approval of the Cash Management Committee (comprised of the Governor, Lieutenant Governor, Speaker of the House of Representatives, and Comptroller of Public Accounts). Proceeds may be in the amount of the projected cash shortfall and such obligations must be repaid within the fiscal biennium in which they were issued.

f. **Toll Project Revenue Bonds**: Subchapter C, Chapter 228, Texas Transportation Code ("Chapter 228") authorizes the Commission to issue toll revenue bonds to finance, in part or in whole, toll projects.

g. **Rail Facility Bonds:** Chapter 91, Texas Transportation Code ("Chapter 91") authorizes the Commission to issue revenue bonds to pay all or part of the cost of developing State-owned rail facilities, as defined in Chapter 91. The Commission is authorized to issue bonds under the same terms and conditions as bonds are issued with respect to toll projects under Chapter 228.

h. **State Infrastructure Bank ("SIB") Revenue Bonds**: Subchapter D, Chapter 222, Texas Transportation Code authorizes the Commission to issue bonds to capitalize the State Infrastructure Bank, such bonds to be secured and payable from income derived from the State Infrastructure Bank.

i. **Texas Rail Relocation and Improvement Fund:** Article III, Section 49-o of the Texas Constitution and Subchapter O, Chapter 201, Texas Transportation Code authorize the Commission to issue bonds to finance the costs of relocating, constructing, reconstructing, acquiring, improving, rehabilitating or expanding publicly- or privately-owned rail facilities. Bonds are payable from revenues deposited to the Rail Relocation and Improvement Fund and the full faith and credit of the State of Texas may be pledged to secure such bonds.

j. **Real Property Financings:** The Commission is authorized under Section 201.1055, Texas Transportation Code, and Section 1232.111, Texas Government Code, to enter into agreements with a private entity for the acquisition, design, construction, or renovation of a building located on TxDOT property or to acquire from a private entity real property, including any improvements, in exchange for TxDOT-owned real property and improvements. In the event that any project is not wholly paid for by an exchange of TxDOT-owned real property, TxDOT may finance the project through the Texas Public Finance Authority, which may issue obligations payable from lease payments by TxDOT to obtain the funds for the remaining cost of the building.

4. Allowable Purposes of Debt Issuance

The statutory authority for the Commission's Financing Programs are outlined in Section 3, however the general purposes for which the Commission may issue debt are as follows:

a. Interim or long-term financing of the construction and acquisition of eligible projects (including feasibility and engineering studies, other preliminary engineering and design activities and the purchase of right-of-way);

b. Reimbursement of the State Highway Fund for qualified expenditures;

c. Major capital improvements, rehabilitations, or repairs to existing Department facilities;

d. Cash management (to the extent permitted by federal tax law); and

e. Refunding of outstanding debt.

Long-term tax-exempt debt may not be used to fund routine operations or maintenance; tax- exempt debt may not be issued for the purpose of investing or for the purpose of earning arbitrage.

5. Eligible Projects

As described in more detail in Section 3, each Financing Program has specifically authorized purposes for which bond proceeds may be used.

6. Long Term Debt Planning

Annually, the CFO shall review and update the long-term debt profile for each Financing Program. The information to be updated includes annual debt service requirements, pledged revenues, planned future issuances and projections of debt service coverage. For unhedged variable rate bonds, an assumed interest rate will be used as prescribed in the legal documents for such Financing Program. If no interest rate is prescribed, the CFO may determine a rate which he deems reasonable.

To the extent possible, these updates shall be considered complete if required as part of the Commission's annual continuing disclosure or other reporting undertakings or as a component of its rating updates.

7. Refunding Procedures and Practices

Refunding of outstanding debt will be considered in order to:

a. <u>Achieve interest rate savings;</u>

The Commission sets forth the following savings guidelines as a measure for evaluating refunding proposals; however the CFO shall have discretion in determining whether to undertake refunding transactions that do not meet the relevant savings or negative arbitrage considerations set forth below. Consideration will be given to compliance with

Commission policy and/or the financial objectives of each Financing Program.

For current refundings, the net present value savings target is 3% of the par amount of bonds refunded.

For advance refundings the net present value savings target is 5% of the par amount of bonds refunded. In addition, the amount of negative arbitrage generated should also be calculated and considered before determining if the obligation should be advance refunded.

For refundings which include the use of derivative products such as interest rate swaps, the transaction must be in compliance with the Commission's Derivative Management Policy. In order to reflect the additional risks associated with such transactions, the net present value savings target is 6% of the par amount of bonds refunded and 8% of the par amount of bonds refunded for transactions in which the Commission assumes tax risk.

The manner in which savings are realized (up front, deferred or on an annual basis) will be determined by the CFO based upon the overall needs and objectives for the specific Financing Program.

b. <u>Restructure principal including conversion of short-term obligations to long-term obligations or alternative interest rate mode obligations;</u>

Refundings involving a restructuring of principal shall be considered if the Commission can achieve a more favorable matching of revenues or other resources pledged to meet debt service payments. Consideration shall be given to the effect of such restructuring on the credit rating (if any) or credit perception of the Financing Program. Any transactions involving the restructuring of principal shall seek to minimize the amount of refunding debt to be issued.

c. <u>Make termination payments due under swap agreements as authorized by the legal documents for such Financing Program and in compliance with the Derivative Management Policy; or</u>

To the extent permitted by law refunding bonds may be issued to make a payment due by the Commission to a qualified counterparty in the event of a termination, whether voluntary or involuntary, for any interest rate swap agreements or similar derivative structures. The Commission shall only issue refunding bonds when other funds legally available to make such a termination payment are insufficient; the issuance of the refunding bonds does not negatively impact the debt service coverage or credit of the Financing Program; or such refunding is contemplated when the derivative product is executed and the derivative complies with the Commission's Derivative Management Policy.

d. <u>Amend or close an existing Trust Indenture or Master Resolution.</u>

Refundings undertaken to revise or remove covenants or to make pledged reserves available for other purposes by closing an existing Indenture or Resolution must analyze any economic impact as measured by present value savings or loss, inclusive of cash contributions and any debt service reserve fund earnings. Such economic effects include:

i. Limitations imposed by the Internal Revenue Code;
ii. Use of reserves;
iii. Future financing capacity; and
iv. Future marketability of related debt.

Other Refunding Considerations

Any debt service reserve funds which are released after a refunding shall be used to reduce the amount of Refunding Bonds to be issued or other authorized purposes and under no circumstances will be used for operating expenses.

8. Limitations on Level of Indebtedness

The Commission and the Department will comply with statutory limitations on the level of indebtedness for each Financing Program. For Financing Programs that are not statutorily limited, the maximum level of indebtedness will be governed by available pledged revenue streams and rate covenants or additional bonds tests contained in the legal documents for such Financing Program. In the case of new financing programs, consideration will be given to the desired credit rating for the program and purpose and use of the revenue stream or fund.

9. Credit Objectives

It is the goal of the Commission to provide sufficient flexibility to meet the objectives of each Financing Program while striving to secure and maintain the highest possible ratings for each Financing Program. It is the objective of the Commission to maintain its positive presence in the credit markets through the maintenance of and improvement of all relevant credit characteristics within its control.

10. Permissible Types of Debt for Financing Programs

a. Variable Rate Debt

Factors to be considered in determining the use of variable rate debt shall include cash flow risk, liquidity risk, remarketing risk and tax risk.

The targeted maximum percentage of unhedged variable rate debt is 25% of outstanding debt for each Financing Program. For purposes of this limitation, variable rate debt is considered hedged if it is subject to an interest rate cap or if short-term investments offset variable rate debt exposure. Short-term investments for purposes of this limitation shall include money invested in money market funds, overnight funds, repurchase agreements, investment pools, and all other TxDOT investments with an average weighted maturity of one year or less. Variable rate debt that is hedged by an interest rate cap or short-term investments is not considered to be subject to tax risk.

The targeted maximum percentage of variable rate debt hedged by interest rate swap products is 25% of outstanding debt for each Financing Program. These targets may be exceeded if the CFO determines doing so to be prudent and consistent with the liquidity and capacity constraints of each Financing Program.

The targeted total percentage of debt for each Financing Program that may be subject to tax risk is 50%.

b. Commercial paper

Commercial Paper may be issued for any Financing Program:

i. To minimize the interest cost or the use of capitalized interest during the design phase or construction period of eligible projects;
ii. For certain equipment purchases or capital improvements;
iii. Cash management (to the extent permitted by federal tax law); or
iv. To diversify the Commission's debt portfolio.

c. Fixed rate debt

Current interest bonds may be used for both new money and refunding transactions and may be structured to meet investor demand at the time of pricing. Current interest bonds may be issued as tax-exempt bonds, taxable bonds or other forms of debt, when advisable. Capital appreciation and zero coupon bonds, which typically result in higher interest costs, shall be used in limited circumstances after an analysis is undertaken that indicates the needs or objectives of a particular Financing Program are met through their use.

d. Derivative products

The Commission will consider the use of interest rate swaps and other interest rate risk management tools after carefully evaluating the risks and benefits of any proposed transaction in accordance with the Derivative Management Policy. By using swaps and other derivative products in a prudent manner, the Commission can take advantage of market opportunities to minimize expected costs and manage interest rate risk. The Commission will not enter into swap transactions for speculative purposes but will consider other swap or derivative products as allowed and recommended pursuant to the Derivative Management Policy.

e. Hedging products

Subject to State law, the Commission may utilize hedging products for the purpose of protecting future debt issuance from interest rate risk. Such products may include, but are not limited to forward delivery bonds or rate locks based on either a taxable or tax-exempt bond index.

11. Permissible Types of Debt for Short-Term Financing Programs

The following types of debt and other obligations are permitted for Section 3(d) Short-Term Obligations and Section 3(e) Highway Tax and Revenue Anticipation Notes:

a. Fixed Rate Notes;
b. Variable Rate Notes;
c. Commercial Paper; and
d. Bank or other Loans

12. Structural Objectives

a. Maturity: Term of debt may not exceed expected useful life of the project(s) or equipment financed, or as statutorily prescribed.

b. Variable rate debt instruments: As long as variable rate debt is outstanding, the CFO will actively monitor and evaluate market conditions and shall determine if it is appropriate and cost-efficient to convert the variable rate debt to fixed interest rates or fixed rate debt to variable rate debt either through the issuance of fixed rate bonds, variable rate bonds or synthetically upon entering into an interest rate swap transaction in compliance with the Derivative Management Policy.

c. Structural elements: In a negotiated sale, use of specific structural elements such as capital appreciation bonds, variable rate bonds, call features, forward delivery bonds, or other debt or derivative products, will be based on information provided by the senior underwriter(s) and on the analysis and recommendation of staff, the financial advisor, and bond counsel, as applicable. For derivative structures, compliance with the Derivative Management Policy is required. In a competitive sale, structural elements will be based on the recommendation of staff, the financial advisor and bond counsel, as applicable.

d. Lien levels: Multiple lien levels of debt may be utilized for any Financing Program if the resulting debt structure optimizes certain critical debt constraints, typically either cost or capacity, or is needed to maintain credit ratings on existing debt. The use of multiple lien levels is also permitted when derivative products are utilized if the Commission will become liable for termination payments or other obligations under such agreements.

e. Capitalized interest: When possible, the Commission will avoid using capitalized interest. The CFO shall determine when the use of capitalized interest is warranted and authorized in order to meet the objectives of any Financing Program.

f. Debt Service Reserve Fund: Debt service reserve funds may be funded by the proceeds of bonds, available cash or cash equivalents, or the purchase of a surety bond to the extent authorized by law. The desirability of using a surety bond to fund a reserve will be evaluated on a case-by-case basis. Debt service reserve funds will be created only when required to market a specific type of debt, achieve a desired credit rating or provide a needed liquidity source for a bond issue.

g. Call provisions: In general, a call provision at the Commission's option must be included for all bonds or obligations with maturities longer than 10 years. The optional redemption date will be a maximum of 10 years from the date of issuance or a date acceptable to the market as recommended by the financial advisor and based on information provided by the senior underwriter(s) on the transaction. Prior to issuing bonds without a call provision, the CFO will evaluate and document expected interest savings in relation to the expected savings from a refunding, as based on the theoretical value of the call option.

h. Credit Enhancement:

   i. Bond insurance: Bond insurance will be used when it provides an economic advantage to a particular bond maturity or entire issue or when a particular product requires the insurance. The decision to use bond insurance shall be based upon the value it adds to a specific transaction. The analysis of that value shall compare the present value of the prospective interest savings produced due to the insurance to the cost of the insurance premium. Insurance may be purchased when the premium cost is less than the projected interest savings. Bond insurance may be purchased for the entire par amount of an issue or for specific maturities thereof, based on a recommendation to TxDOT from the financial advisor regarding the most cost-effective approach or upon information provided by the senior underwriter(s) that insurance is desirable to attract investors who are willing to pay for such insurance. In no case will TxDOT purchase insurance if there is a cost to the Department. Bids from bond insurers will be solicited from qualified providers on a case-by-case basis given current market conditions and insurer ratings. The CFO will authorize the purchase of bond insurance if it is deemed prudent, reasonable and cost-effective.

   ii. Liquidity/Credit facilities: The issuance of variable rate debt, including variable rate bonds and commercial paper, may require the use of a liquidity and/or credit facility. Letters of Credit, Revolving Credit Agreements and Standby Bond Purchase Agreements will be considered as credit enhancement based on the specific need of the short-term instrument and cost-effectiveness. The Department will solicit bids from qualified financial institutions established in this line of business and select the "best value" based on price, financial stability, terms and conditions and service. Qualified financial institutions must have short-term ratings from two rating agencies of at least

"P-1", "A-1" or "F1" at the time the agreements are executed.

13. Method of Sale

The Commission recognizes that each issuance of obligations has unique characteristics that will provide the basis for determining the appropriate method of sale. Such methods include competitive sale, negotiated sale, or private placement. The conditions which indicate the appropriate method of sale are generally described below:

a. Competitive Sale:

i. The bond market is stable and/or demand for bonds is strong;
ii. Market conditions and interest rate sensitivity are not critical to the pricing;
iii. Women, veterans with disabilities or minority owned firm participation is on a best efforts basis only and is not required for the winning bid;
iv. There are no complex explanations required during marketing regarding the project, funding mechanism or credit quality;
v. Credit is well known to investors;
vi. Bond type and features are conventional; and/or
vii. The transaction size is manageable.

b. Negotiated Sale:

i. Market conditions are volatile and demand for bonds is weak;
ii. Coordination of multiple components of the financing is required;
iii. Participation by women, veterans with disabilities or minority owned firms is desired or enhanced;
iv. For complex credit structures where substantial education of investors will be required as to the project, the credit or the structure of the transaction;
v. Structural features are unconventional, such as forward delivery bonds or derivatives; or structure is not conducive to competitive sale;
vi. Large transaction size; and/or
vii. A financing structure where retail participation is targeted.

c. Private Placement:

A private placement with a sophisticated investor including a bank loan may be appropriate when:

i. Credit is weak or credit ratings cannot be obtained;
ii. A loan provides more advantageous terms than the capital markets;
iii. A favorable innovative or proprietary structure is proposed that is unavailable in the markets generally; and/or
iv. Time is of the essence and a private placement can be consummated more quickly than a public offering.

14. Use and Investment of Bond Proceeds

Any investment of bond proceeds shall be executed in accordance with the Commission's Investment Policy, Investment Strategies, legal covenants, and State and federal tax law limitations. The investment of debt proceeds of all of the Commission's Financing Programs are subject to the Public Funds Investment Act.

15. Escrow Structuring

The preference of the Commission is to utilize State and Local Government Series Securities

(‘SLGS”), when available in structuring refunding escrows. In circumstances where open market securities provide material cost savings compared to SLGS (when SLGS are available for purchase), a certificate shall be delivered to the CFO from the financial advisor or qualified third party agent, who is not a broker-dealer, on each refunding issue. The certificate shall state that the securities were procured through an arms-length, competitive bid process, that such securities were more cost-effective than SLGS, and that the price paid for the securities was reasonable within federal tax law guidelines.

16. Compliance with Arbitrage Rebate

The use and investment of bond proceeds for all Financing Programs shall be monitored to ensure compliance with arbitrage restrictions. Existing regulations generally require that issuers calculate annual rebate requirements related to any bond issues and pay any required rebate every five years. Therefore, the CFO shall ensure that bond proceeds and investments are traced in a manner which facilitates the completion of accurate rebate calculations, and rebate payments, if any, are made in a timely manner. A nationally-recognized arbitrage rebate services firm may be used to consult, calculate and report the required arbitrage rebate payments as required by federal tax law.

17. Continuing Disclosure

The Commission shall comply with U.S. Securities and Exchange Commission Rule 15c2-12 by filing with the Electronic Municipal Market Access system (“EMMA”) of the Municipal Securities Rulemaking Board annual financial statements and other financial and operating data for the benefit of its bondholders no later than six months after the end of each fiscal year. The inability to make timely filings must be disclosed promptly.

18. Selection of Consultants

Pursuant to applicable State law, the Department shall select its financial advisors, investment banking firms, bond counsel and disclosure counsel by a competitive process through the issuance of a Request for Proposals (“RFP”) or a Request for Qualifications (“RFQ”). Unless applicable State law requires otherwise, selection may be based on a best value approach for professional services or the lowest responsive cost-effective bid based upon predetermined criteria.

a. <u>Financial Advisor:</u> PFD will have the responsibility of selecting an advisor (or advisors) to assist with the issuance of all debt and debt administration processes relating to any or all of the Commission’s Financing Programs.

b. <u>Investment Banking Firms</u>: PFD will select an underwriting pool of investment banking firms to serve as senior manager, co-senior and/or co-manager as bond underwriters. The pool will include a broad representation of national, regional, women, veterans with disabilities and minority owned firms. Firms that are selected to be in the pool shall acknowledge and agree to comply with the Underwriting Procedures herein.

c. <u>Bond/Disclosure Counsel</u>: Debt of the Commission shall be issued with a written opinion by qualified bond counsel affirming that the Commission is authorized to issue the proposed debt, that the Department has met all constitutional and statutory requirements necessary for issuance, and a determination regarding the debt’s federal income tax status. Bond counsel must be engaged to provide an expert and objective legal opinion with respect to the validity of all Department debt obligations and the tax treatment of interest on the debt obligations. Disclosure Counsel will also be used to prepare offering documents and will be responsible for ensuring compliance with all applicable disclosure rules, regulations and guidelines. The General Counsel Division will have the responsibility of selecting such counsel and may appoint a pool of bond counsel firms and select qualified firms from the pool to act as either Bond or Disclosure Counsel for each transaction.

19. Underwriting Procedures

a. Underwriting Syndicate: PFD is authorized to select the size and composition of each syndicate from the pool based generally on the following factors: 1) initiation and implementation of innovative financing ideas or structures; 2) the expertise of bankers required for the transaction; 3) the underwriting capabilities, as determined by excess net capital and distribution networks, relative to the size of the transaction; and 4) performance of each syndicate member in past transactions. Inclusion in the underwriting pool does not guarantee participation in any of the proposed financings nor is there a guarantee that any firm will participate in a minimum or maximum number of financings or financings of any minimum or maximum dollar amounts.

b. Transaction Marketing Activities: The senior book-running manager must provide marketing plan to the CFO in advance of each transaction. The marketing plan should be developed in collaboration with the entire syndicate to ensure meaningful participation of the entire syndicate. The marketing plan should include potential target investors, pre-marketing activities, structural recommendations such as call features and use of term bonds, a recommendation as to the use of retention, designation rules and proposed liabilities. All decisions regarding retention, designation policies and liabilities will be made by the CFO.

c. Post-Sale Evaluation: After the completion of each transaction, the senior manager will be required to present a post-sale analysis including but not limited to pricing, orders and allocations, comparable sales and indices, designations, market conditions at pricing and other information required to satisfy reporting required by the Texas Bond Review Board. In addition, the senior manager should provide a listing of all investors receiving allotments including the amount of such allotment and a contact email. The CFO or PFD Director and financial advisor will evaluate the success of the underwriting versus the market at the time of sale and analyze each syndicate member's contribution with regard to sales performance.

d. Unsolicited Proposals: The Department encourages the submission of financing options and ideas from any firm and may accept proposals from firms that are not in the pool. All proposals should include a full analysis of risks and benefits associated with each transaction, and a description of previous experience with such financing technique, if any.

   The Department reserves the right to issue RFPs for any product or transaction. If the firm submitting an innovative proposal that is implemented by the Department is not a member of the pool, the Department may consider a structuring fee and/or inclusion as a co-manager or co-senior manager as compensation.

Derivative Management Policy

August 27, 2020

CONTENTS

I. Introduction

This Derivative Management Policy ("Policy") is a subsidiary component of and should be read in conjunction with Texas Transportation Commission's ("Commission") Debt Management Policy. The purpose of this Policy is to establish responsibilities, objectives, and guidelines for the use of interest rate swaps and similar products to manage the Commission's asset/liability profile for each Financing Program (Financing Programs are described in the Debt Management Policy). As used in this document, Commission debt also includes debt or other obligations issued by the Texas Department of Transportation ("TxDOT" or "Department") on behalf of the Commission and debt issued by related entities on behalf of the Commission or the Department, and excludes any debt where the Commission may act as a conduit issuer.

The Commission is authorized pursuant to Chapter 1371, Texas Government Code, as amended, to enter into credit agreements that include interest rate swap and other similar agreements.

II. Policy Objectives and Philosophy

This Policy describes guidelines within which each interest rate swap and other similar transaction, including termination of an interest rate swap or other similar transaction ("Transactions") are to be used to manage the Commission's asset/liability portfolio by 1) balancing risk exposures related to fluctuating interest rates and other economic variables, 2) minimizing debt service cost, 3) balancing or rebalancing the ratio of fixed and variable rate debt, 4) responding to market conditions or interest rate cycles that offer value to the Commission and 5) hedging future interest rate conditions. Transactions will not be employed as investment instruments or for the purpose of speculation.

This Policy shall govern the use and management of all Transactions. While the Commission will require adherence to this Policy in applicable circumstances, it recognizes that changes in the law, capital markets, Commission programs and other unforeseen circumstances may from time to time produce situations that are not covered by this Policy and will require modifications or exceptions to achieve policy goals. In these cases, management flexibility may be granted through specific authorization from the Commission.

It is the Commission's intention to enter into Transactions in a prudent and professional manner that will take into account the Commission's objectives in managing its assets and liabilities, relevant risk factors, and market conditions. All Transactions shall comply with State statutes and Commission policies governing such transactions.

III. Management and Oversight

Management responsibility for the Derivative Management Policy is hereby delegated to the Chief Financial Officer or the Director of the Project Finance, Debt and Strategic Contracts Division as his designee ("CFO") in consultation with the Derivative Policy Committee (the "Derivative Committee"). A member of the Derivative Committee may not be designated, and may not have management responsibility for derivative management policy, while a member of the Derivative Committee.

By prior authorization of the Commission, a Derivative Committee has been formed. The Derivative Committee is an advisory body only, formed for the purpose of making recommendations to the CFO. The Derivative Committee shall consist of the following members: 1) the Project Finance, Debt and Strategic Contracts Division shall have one member that is not also the director, 2) the

Financial Management Division shall have one member as designated by the Financial Management Division Director, 3) the General Counsel Division shall have one member who shall be a non-voting member, 4) and the Commission shall designate a representative (non-Commissioner) as a voting member. Commissioners and their individual representatives may attend Derivative Committee meetings as non-voting members. The directors of the Financial Management and the Project Finance, Debt and Strategic Contracts divisions and the General Counsel will provide to the CFO, in writing, the names of the representatives authorized to represent their divisions on the Derivative Committee.

A quorum of the Derivative Committee shall be two voting members. If a quorum is present, the vote of a majority of the members present, as to any recommendation to be made by the Derivative Committee, controls.

The representative of the Project Finance, Debt and Strategic Contracts Division, or the representative of the Financial Management Division in his or her absence, shall chair the Derivative Committee.

Responsibilities

The CFO will have the following responsibilities:

- making recommendations to the Commission after consultation with the Derivative Committee prior to the execution of any Transaction;
- monitoring each outstanding Transaction on at least a monthly basis by reviewing mark-to-market values, current cash flows, or other metrics;
- making recommendations to the Commission after consultation with the Derivative Committee when early indicators signal action may be required or necessary;
- providing a quarterly report to the Derivative Committee, as outlined in Section IX of this Policy, detailing the status and other matters relating to each outstanding Transaction, if any;
- acting as an information resource to the Derivative Committee and Commission at any time requested; and
- providing an annual report to the Commission, as outlined in Section IX of this Policy, detailing the status and other matters relating to each outstanding Transaction, if any.

The Derivative Committee is responsible for the following, but solely as an advisory committee:

- oversight of all Transactions to ensure compliance with the guidelines and restrictions established by this Policy and making recommendations to the CFO as to any perceived necessity for action;
- making recommendations to the CFO regarding the approval of each Transaction, including the termination of any Transaction;
- annual review of this Policy.

IV. Guidelines

The Commission, on the recommendation of the CFO after consulting with the Derivative Committee, may enter into any of the following Transactions: interest rate swaps, basis swaps, interest rate caps, interest rate floors, interest rate collars, options on interest rate swaps, forward-starting interest rate swaps or other similar Transactions, and may from time to time shorten, terminate, extend, or otherwise modify Transactions in order to manage its risk exposure, balance assets and liabilities, or reduce debt cost.

The following are Commission policies regarding these Transactions:

Approved Purposes for Transactions

1. To achieve savings as compared to a product available in the cash/bond market. Savings shall be calculated after adjusting for (a) applicable fees, including takedown, remarketing fees, credit enhancement, advisory and legal fees, and (b) the value of call options that may be foregone on the related debt obligations.
2. To prudently hedge risk in the context of a particular financing or the overall asset/liability management. Examples include, but are not limited to, interest rate caps, rate locks and forward starting swaps.
3. To incur variable rate exposure within prudent guidelines, such as selling interest rate caps or entering into a swap in which the Commission's payment obligation is based on a floating rate.
4. To achieve more flexibility in meeting overall financial objectives than can be achieved in conventional markets. A basis swap would be an example of this type of Transaction.
5. To achieve diversification of the Commission's asset/liability portfolio.
6. To achieve diversification of counterparty exposure.
7. To achieve any other Commission objective not listed above as described in a specific authorization of the Commission.

General Guidelines

1. Each Transaction recommended by the CFO must comply with the following guidelines, except as otherwise provided herein or in unusual market conditions, and all applicable legal documents, insurance covenants, and state and federal law.
2. The CFO will consider in his/her recommendations, published rating agency guidelines in connection with each Transaction.
3. All Transaction documents must contain terms and conditions as set forth in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement, Schedules to the Master Agreement, Credit Support Annex and confirmation, as appropriate and consistent with industry standards.
4. Except as otherwise permitted in Section VI of this Policy, each Transaction must be a market transaction for which competing good faith market quotations may be obtained or can reasonably be expected to be obtained.
5. Early termination provisions must be included in each Transaction. Generally such provisions will provide for a termination at the sole option of the Commission. Should the Commission exercise its right to optionally terminate a Transaction, a benefit to the Commission must be demonstrated.
6. A Transaction will not be assignable to another counterparty without the approval of the Commission.
7. Aside from customary market termination provisions, the Commission will not enter into a Transaction which will impair its utilization of call features on outstanding debt obligations.
8. Generally, the Commission will not enter into Transactions that require posting of collateral by the Commission. However, if and when market considerations, such as the credit quality of the underlying bonds or obligations, so dictate, the CFO may recommend two-way collateral posting.

Legality

Enforceability opinions reviewed by the General Counsel and acceptable to the Commission and the Counterparty will be required for each Transaction.

Aspects of Risk Exposure Associated with Such Transactions

Before entering into a Transaction, the CFO and Derivative Committee shall evaluate all the risks and requirements inherent in the Transaction and provide such information to the Commission. (See Exhibit I for a more detailed review of risks.)

Counterparty Exposure Limitation

It is Commission policy to diversify its exposure to counterparties. To that end, before entering into a Transaction, the CFO and Derivative Committee should determine the Commission's exposure to the relevant counterparty or counterparties and determine how the proposed Transaction would affect such exposure.

The CFO will evaluate counterparty exposure based upon both the credit rating of the counterparty as well as the relative level of risk associated with each existing and proposed Transaction on an ongoing basis as well as prior to any proposed Transaction. For outstanding Transactions, exposure will be based on the market value as of the last quarterly report to the Derivative Committee or other appropriate method of determining Value at Risk. Projected exposure shall be calculated quarterly based on the Transaction's potential termination value taking into account possible adverse changes in interest rates.

If exposure to any counterparty for any reason is determined by the CFO to be excessive, the CFO, in consultation with its legal counsel and financial advisor, shall explore remedial strategies to mitigate such exposure. The CFO will provide the results of this endeavour to the Derivative Committee in order to formulate a remedial plan, including any recommendations from the CFO to the Commission.

Long-Term Implications

In evaluating a particular Transaction, the CFO and Derivative Committee shall review the long-term implications associated with each Transaction, such as costs of borrowing, historical interest rate trends, variable rate capacity, credit enhancement capacity, opportunities to refund related debt obligations, counterparty exposure and other similar considerations.

Methods to be Used to Reflect Such Contracts in TxDOT's Financial Statements

The Department shall reflect the use of Transactions on its financial statements in accordance with Generally Accepted Accounting Principles ("GAAP").

V. Approval of Transactions

The Department desires to establish an approval structure that provides adequate Commission oversight of Transactions while maintaining flexibility to execute such Transactions in a timely manner.

The following structure and Transaction approval procedures are established.

a. The Commission, from time to time and upon recommendation of the CFO, who shall consult with the Derivative Committee as to its recommendations, may authorize general parameters for Transactions or a program of Transactions for a particular financing to be executed by the CFO.

b. The CFO shall review specific parameters for Transactions within any general parameters authorized by the Commission. All general parameters and any specific parameters that the CFO deems significant will be detailed in the Term Sheet. (See Exhibit II for example terms.) Specific parameters commonly incorporated into a term sheet following approval by a governing body may be so incorporated into a term sheet with the approval of the CFO in consultation with the Derivative Committee.

c. The CFO shall structure specific parameters for the termination of any existing Transaction upon determination that such action is in the best interests of the Commission. Such recommendations will be reviewed and approved by the Derivative Committee.

VI. Methods of Soliciting and Procuring Transactions

It is the Commission's goal to have ISDA Master Agreements and associated Schedules for each Financing Program. In order to be considered a pre-qualified counterparty, execution of these agreements will be required prior to the price execution of any Transaction. In each ISDA Master Agreement, the Commission may pledge all legally available funds specific to each Financing Program or otherwise provide security for its obligations under the ISDA Master Agreements governing the Transactions.

In general, it is a Commission guideline that the Department will, to the extent practical using best efforts, employ a competitive bidding process. A competitive bid procurement will require the number of firms solicited to be no fewer than three. The CFO, in consultation with the financial advisor and other staff of the Department, shall determine which parties will be invited to participate in a competitive transaction. Should only one counterparty bid, then the CFO must evaluate other policy guidelines, such as concentration of counterparty exposure.

Notwithstanding the above, it is a Commission guideline to enter into Transactions by negotiated methods in the following situations:

1. The CFO makes a determination that due to the size or complexity of a particular Transaction or because of current market conditions, a negotiated transaction would result in the most favorable execution. In this situation, the Department, through the CFO, should attempt to price the Transaction based upon a methodology agreed to by the CFO and the counterparty relying on available pricing screens to obtain inputs to a financial model. The CFO may use the Department's financial or swap advisor to assist in price negotiations or to verify bids.
2. A proposed Transaction is embedded within a refunding bond issuance and meets the Commission's savings target.
3. The CFO determines, in light of the facts and circumstances of a particular Transaction, that a negotiated Transaction will promote the interests of the Department/Commission by encouraging and rewarding innovation.
4. In order to achieve counterparty diversification.

Commission guidelines also require that entering into Transactions by negotiated methods is contingent upon the counterparty providing the following items:

- a statement that the difference (if any) in basis points between the rate of the Transaction and the mid-market rate for a comparable transaction falls within the commonly occurring range for comparable transactions;
- a statement of the amount of the difference as determined by the counterparty;
- if the counterparty does not know of a comparable transaction or mid-market rate, a statement of another suitable measure of pricing acceptable to the counterparty.

Regardless of the method of procurement, the Department's financial advisor or other qualified independent advisor shall provide a certification that the terms and conditions of any Transaction entered into reflect a fair market value of such Transaction as of the date of its execution. Additionally, the counterparty will provide a statement disclosing any payments made to another person to procure the Transaction with the Commission.

VII. Counterparty Requirements

It is Commission policy that the following conditions should apply to each Transaction:

a. The CFO shall request that the counterparty fully disclose all costs including associated fees and costs. All fees and expenses paid by the counterparty to designated third parties will be fully disclosed in writing to the Commission in the confirmation for each Transaction.

b. Provisions for protection in the event of a counterparty downgrade, including collateral or credit support shall be incorporated.

c. The counterparty shall disclose relationships with other third parties which may affect the Transaction, such as broker-dealers, insurance companies, other swap providers and the Commission's financial advisor.

d. The counterparty shall provide its most recent financial audit and credit ratings, which shall be acceptable to the Commission.

e. At the time of entering into a Transaction, the counterparty shall be rated at least AA-/Aa3 by at least one nationally-recognized rating agency and not on rating/credit watch where a rating downgrade to below AA-/Aa3 may be imminent, or have, as support for its obligations, a "AA-/Aa3" subsidiary or other entity as rated by at least one nationally-recognized rating agency that can also meet all other counterparty requirements.

VIII. Restrictions

The following are Commission policies relating to restrictions on Transactions:

a. The Commission will not enter into Transactions for speculation.

b. The Commission will not execute any Transactions with a term greater than the final maturity of its related outstanding long-term indebtedness.

c. The Commission will not enter into a Transaction for an investment-related purpose.

d. The total "net notional amount" of all swaps related to bonds or other indebtedness is not to exceed the amount of related outstanding bonds or indebtedness. For purposes of calculating the net notional amount, credit shall be given in situations where there are off-setting swaps.

IX. Early Warning Monitoring and Reporting for Existing Transactions

The CFO will monitor existing Transaction cash flows, market values and early warning indicators on an ongoing basis (no less than monthly). The CFO will provide, after consultation with the Derivative Committee, a recommended course of action when early warning indicators dictate action is required. The list of "early warning indicators" can be expanded as needed but will include the following at a minimum:

a. A market movement that requires a collateral deposit or is within 10% of such requirement.
b. Any rating action with respect to a counterparty that may result in a rating downgrade to a level lower than the requirements specified in Section VII of this Policy.
c. A rating action on any financing program that could result in a collateral deposit as may be required under an ISDA agreement.
d. A change in tax law or a likely permanent market shift that produces or is likely to produce negative cash flows where the Department must make payments to a counterparty.
e. Any unforeseen event that significantly, negatively impacts the expected results of the Transaction and that is likely to continue.

While derivative transactions are outstanding, at least annually, the CFO or his designee shall present a written report to the Commission, on all outstanding Transactions as of the end of the fiscal year. At least quarterly the CFO will present a written report to the Derivative Committee while derivative transactions are outstanding. The reports shall contain at a minimum the following items:

1. A description of the terms of each outstanding Transaction.
2. A statement of:
    a. The fair market value of each Transaction as of the end of the reporting period.
    b. The amount of any collateral posted by the Commission or by a counterparty during the period.
    c. A summary of the cash flows for each Transaction during the period.
3. A list, including the credit rating, of counterparties and any guarantor for a counterparty for each Transaction.
4. A measurement of the performance of the trade versus projections at the time of execution.

The CFO, in consultation with the Derivative Committee, may provide any recommendations to the Commission regarding the transactions and recommend any changes to the Derivative Management Policy.

X. Exit Strategies

In the event of termination, whether voluntary or involuntary, the Derivative Committee, upon recommendation of the CFO, will evaluate the best possible strategy given the market, tax, legal and economic environment at the time of termination. The following are general guidelines for voluntary and involuntary termination strategies:

a. Voluntary Termination: The CFO will monitor market rates, termination values, tax changes, counterparty credit ratings, and any other relevant factors to determine if Voluntary Termination is warranted. Generally, an early termination will be warranted if it is economically advantageous for the Commission to do so, a more beneficial underlying debt structure can be attained or it will alleviate a current or anticipated risk inherent to the Transaction. Based upon expected market conditions at the proposed termination date, the CFO, in consultation with the Derivative Committee, will establish a strategy prior to termination to hedge any exposure that is created by the termination.

b. Involuntary Termination: If certain events occur, such as a substantial ratings downgrade of any of the Commission's Financing Programs, involuntary termination may occur. Depending on market conditions, this may result in an obligation of the Commission to make a significant termination payment to the counterparty. In the event of a termination payment, the source of payment will be from legally and currently available sources for each Financing Program, including any collateral posted, insurance and/or reserves set up for this purpose. As soon as early warning monitoring indicators show that an involuntary termination may occur in the near term, the CFO, in consultation with the Derivative Committee, will establish a strategy to hedge any exposure based on then-prevailing market conditions. This strategy shall be monitored by the CFO and updated regularly in order to ensure that the strategy appropriately reflects changing market conditions.

EXHIBIT I: Risks Associated with Derivatives

Counterparty Risk - Risk that the counterparty cannot make future payments or cannot make a termination payment due to the Commission.

Mitigation of Risk - Risk is reduced by a highly-rated counterparty and by ISDA contract terms addressing collateral limits and credit ratings. Selecting more than one counterparty will diversify risk. The high rating requirements set forth for qualified counterparties will increase the likelihood that their financial commitments will be met.

Basis Risk - Risk that the payment on the variable rate debt obligations will exceed the swap receipt (the Securities Industry and Financial Markets Association or "SIFMA" Index or a percentage of the London Interbank Offered Rate or "LIBOR") due to an issuer-specific credit event or tax code change.

- Tax Event Risk - A form of basis risk - risk of higher tax-exempt interest rates (an increase in SIFMA Index) if tax law revisions lower the tax rate on interest income. In the extreme scenario, if a change in tax law eliminated tax-exempt interest income, the market would adjust "tax-exempt" security pricing so that there would be no material difference between the SIFMA Index and LIBOR.
- Credit Risk - Credit deterioration of the underlying debt obligations or any bond insurer, letter of credit provider, or liquidity provider insuring or enhancing the related debt obligations would result in basis risk discussed above.

Mitigation of Risk – Methods of mitigating this risk include: specifying in the agreement a percent of LIBOR which reflects historical trading relationships and scheduled future tax cuts or using a SIFMA based rate; limiting the amount or percentage of debt subject to tax event risk; managing operations and cash reserve balances as efficiently as possible; and analyzing and implementing procedures to maintain credit stability.

Termination Risk - Termination risk exists if (i) the Commission opts to terminate the swap prior to maturity; (ii) credit ratings for any Financing Program are lowered to below investment grade and the Department is unable or is not required to post collateral, as may be required by the swap agreements, to protect the counterparty against the risk resulting from the lowered rating; (iii) the counterparty is downgraded and the counterparty is unable to post collateral; or (iv) the counterparty is downgraded to a level that causes an involuntary termination. Early termination would be solely at the option of the Commission (except in certain credit events described in (ii) above). It is Commission policy that the counterparty will not have the option to terminate at any time without cause.

Mitigation of Risk – The Commission's strong financial standing makes the likelihood of early involuntary termination remote for the majority of its Financing Programs, however, lower-rated credits such as project revenue bonds may be vulnerable to termination risk. In the event of a termination, TxDOT may be required to make a termination payment to the swap provider. In the absence of market changes, the magnitude of the termination payment generally decreases over time as the Transaction approaches maturity. If a termination payment were to be made, the financial impact would be mitigated by the savings which had been gained through the swap prior to termination. If the swap is allowed to mature, there will be no termination payment. The possibility of a future termination payment puts more pressure on the Department to maintain sufficient reserves and to maintain investment grade credit ratings on all of its Financing Programs. Risk of involuntary termination due to counterparty downgrade is mitigated by a collateral posting requirement, and the use of a diverse group of highly-rated counterparties.

Rollover Risk – Potential rollover risk exists if the swap maturity does not match the maturity of the hedged debt or asset. If the Commission chooses to enter into another swap transaction to hedge the related debt or asset, the Commission may not be able to have the same counterparty or achieve the same economic benefit with the next swap transaction.

Mitigation of Risk – Rollover risk may be mitigated by structuring swap transactions to mirror the maturity of the underlying debt obligations and/or related assets of the Commission.

Disclosure Risk - Accounting standards may require balance sheet and income statement entries for swap agreement interim values. For example, if an upfront payment structure were considered and legally acceptable, then TxDOT would have to show a negative value for the first several years even if rates remained the same.

Mitigation of Risk - Retain a reasonable cash reserve in case of termination and structure the swap to minimize the impact of early termination.

Exhibit II: Example Summary Term Sheet

Title of Proposed Issue or Transaction

INDICATIVE TERMS AND CONDITIONS

Issuer:	Texas Transportation Commission
Issue/Contract:	
Amount:	Par and/or Notional Amount not to exceed $XXX
Use of Proceeds:	If debt obligations are being issued.
Bonds Refunded (if any):	
Refunded Par (if any):	
Description of Derivative Transaction Structure, including debt/swap instruments:	
Rate Methodology:	SIFMA, % of LIBOR
Amortization:	
Early Termination Provisions (if any):	
Average Life/Term or Designated Maturity:	
Revenue Pledge:	
Estimated Synthetic Fixed/Variable Rate PV Savings:	
Upfront Costs of the Transaction:	
On-going Costs of the Transaction:	
Benefits/Reasons for the Transaction:	
Risks and Mitigation Measures:	
Proposed Counterparties and Current Credit Rating:	
Method of Selection of Counterparties:	
Financial Advisor and Associated Transaction Fees:	
Legal Advisor and Associated Transaction Fees:	